PLYMOUTH CITY COUNCIL

Subject:	Treasury Management Strategy and Annual Investment Strategy 2016/17 including Minimum Revenue Provision (MRP) Strategy 2016/17
Committee:	Cabinet
Date:	16 February 2016
Cabinet Member:	Councillor Lowry
CMT Member:	Andrew Hardingham (Assistant Director for Finance)
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Ref:	Fin/CF
Key Decision:	No
Part:	I

Purpose of the report:

The Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice for Treasury Management in Public Services requires local authorities to set a Treasury Management Strategy Statement and Prudential Indicators on an annual basis to include the Annual Investment Strategy.

The Brilliant Co-operative Council Corporate Plan 2013/14 -2016/17:

Effective financial management is fundamental to the delivery of corporate improvement priorities. Treasury Management activity has a significant impact on the Council's activity both in revenue budget terms and capital investment and is a key factor in facilitating the delivery against a number of corporate priorities.

Implications for Medium Term Financial Plan and Resource Implications: Including finance, human, IT and land

Treasury Management affects the Council's budget in terms of borrowing costs and investment returns. The Treasury Management Strategy sets the authorised limits and operational boundaries within which investment and borrowing decisions are taken and risks managed. Effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable performance measurement techniques, within the context of effective risk management.

Other Implications: e.g. Child Poverty, Community Safety, Health and Safety and Risk Management:

A robust Treasury Management Strategy is key to ensuring a successful delivery of our Medium Term Financial Plan and ensuring the Council can achieve its objectives to be a Pioneering, Growing Caring and Confident City.

Equality and Diversity

Has an Equality Impact Assessment been undertaken? No

Recommendations and Reasons for recommended action:

1. Cabinet recommends the Treasury Management Strategy and Annual Investment Strategy (incorporating the authorised limits, operational boundaries and prudential indicators) to the Council for approval

This is to comply with the Cipfa Code of Practice and discharge our statutory requirement.

2. Cabinet recommends Council to approve the change of policy in the calculation of the Minimum Revenue Provision using the annuity method with effect from 2015/16.

Alternative options considered and rejected:

It is a statutory requirement under the Local Government Act 2003 and supporting regulations to set an annual treasury strategy for borrowing and prepare an annual investment strategy. The Council has adopted the CIPFA Code of Practice for Treasury Management.

Published work / information:

Not Applicable

Background papers:

Not Applicable

Title	Part I	Part II	Exemption Paragraph Number						
			1	2	3	4	5	6	7

Sign off:

Fin	djn15 16.69	Leg	lt/24 948	Mon Off	DVS 24947	HR		Assets		IT		Strat Proc	
Originating SMT Member Andrew Hardingham, Assistant Director													
Has the Cabinet Member(s) agreed the contents of the report? Yes													

Treasury Management Strategy Statement 2016/17 and Annual Investment Strategy 2016/17

1. Introduction

1.1 In April 2002 the Authority adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* (the CIPFA Code) which requires the Authority to approve a treasury management strategy before the start of each financial year.

1.2 In addition, the Department for Communities and Local Government (CLG) issued revised *Guidance on Local Authority Investments* in March 2010 that requires the Authority to approve an investment strategy before the start of each financial year.

1.3 This report fulfils the Authority's legal obligation under the *Local Government Act 2003* to have regard to both the CIPFA Code and the CLG Guidance.

1.4 The Authority has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Authority's treasury management strategy.

2 External Context

2.1 Economic background

Domestic demand has grown robustly, supported by sustained real income growth and a gradual decline in private sector savings. Low oil and commodity prices were a notable feature of 2015, and contributed to annual CPI inflation falling to 0.1% in October. Wages are growing at 3% a year, and the unemployment rate has dropped to 5.4%. Mortgage approvals have risen to over 70,000 a month and annual house price growth is around 3.5%. These factors have boosted consumer confidence, helping to underpin retail spending and hence GDP growth, which was an encouraging 2.3% a year in the third quarter of 2015. Although speeches by the Bank of England's Monetary Policy Committee (MPC) members sent signals that some were willing to countenance higher interest rates, the MPC held policy rates at 0.5% for the 81st consecutive month at its meeting in November 2015. Quantitative easing (QE) has been maintained at £375bn since July 2012.

A major political issue in 2016 will be the UK's future relationship with the EU. Uncertainty over the outcome of the forthcoming referendum could put downward pressure on UK GDP growth and interest rates.

China's growth has slowed and its economy is performing below expectations, reducing global demand for commodities and contributing to emerging market weakness. US domestic growth has accelerated but the globally sensitive sectors of the US economy have slowed. Strong US labour market data and other economic indicators however suggest recent global turbulence has not knocked the American recovery off course. The Federal Reserve did not raise policy rates at its meetings in October and November, but the statements accompanying the policy decisions point have made a rate hike in December 2015 a real possibility. In contrast, the European Central Bank finally embarked on QE in 2015 to counter the perils of deflation.

2.2 Credit outlook

The varying fortunes of different parts of the global economy are reflected in market indicators of credit risk. UK Banks operating in the Far East and parts of mainland Europe have seen their perceived risk increase, while those with a more domestic focus continue to show improvement. The sale of most of the government's stake in Lloyds and the first sale of its shares in RBS have generally been seen as credit positive.

Bail-in legislation, which ensures that large investors including local authorities will rescue failing banks instead of taxpayers in the future, has now been fully implemented in the UK, USA and Germany. The rest of the European Union will follow suit in January 2016, while Australia, Canada and Switzerland are well advanced with their own plans. Meanwhile, changes to the UK Financial Services Compensation Scheme and similar European schemes in July 2015 mean that most private sector investors are now partially or fully exempt from contributing to a bail-in. The credit risk associated with making unsecured bank deposits has therefore increased relative to the risk of other investment options available to the Authority; returns from cash deposits however remain low.

2.3 Interest rate forecast

The Authority's treasury advisor Arlingclose projects the first 0.25% increase in UK Bank Rate in the third quarter of 2016, rising by 0.5% a year thereafter, finally settling between 2% and 3% in several years' time. Persistently low inflation, subdued global growth and potential concerns over the UK's position in Europe mean that the risks to this forecast are weighted towards the downside.

A shallow upward path for medium term gilt yields is forecast, as continuing concerns about the Eurozone, emerging markets and other geo-political events weigh on risk appetite, while inflation expectations remain subdued. Arlingclose projects the 10 year gilt yield to rise from its current 2.0% level by around 0.3% a year. The uncertainties surrounding the timing of UK and US interest rate rises are likely to prompt short-term volatility in gilt yields.

A more detailed economic and interest rate forecast provided by Arlingclose is attached at ***Appendix A***.

For the purpose of setting the budget, it has been assumed that new investments will be made at an average rate of 1.14%, and that new long-term loans will be borrowed at an average rate of 3.51%.

3. Local Context

3.1 The Authority currently has £230m of borrowing and £68m of investments. The Economic & Interest Rate Forecast is set out in further detail at ***Appendix B***. Forecast changes in these sums are shown in the balance sheet analysis in table 1 below.

<u>Table 1: Balance Sheet Summary and Forecast</u>

	31.3.15 Actual £m	31.3.16 Estimate £m	31.3.17 Forecast £m	31.3.18 Forecast £m	31.3.19 Forecast £m
General Fund CFR	290.94	313.50	329.23	337.67	342.67
Less: Other debt liabilities *	-38.94	-38.94	-38.00	-38.00	-38.00
Borrowing CFR	**252.00**	**274.56**	**291.23**	**299.67**	**304.67**
Less: External borrowing **	-215.46	-238.02	-253.75	-262.19	-267.19
Internal (over) borrowing	**36.54**	**36.54**	**37.48**	**37.48**	**37.48**
Less: Working Capital /Usable	114.10	111.00	89.00	87.00	85.00
Investments (or New borrowing)	**77.56**	**74.46**	**51.52**	**49.52**	**47.52**

* finance leases, PFI liabilities and transferred debt that form part of the Authority's total debt

** shows only loans to which the Authority is committed and excludes optional refinancing

3.2 The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. The Authority's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing, subject to holding a minimum investment balance of £52m.

3.3 CIPFA's *Prudential Code for Capital Finance in Local Authorities* recommends that the Authority's total debt should be lower than its highest forecast CFR over the next three years. Table 1 shows that the Authority expects to comply with this recommendation during 2016/17.

4 Borrowing Strategy

4.1 The Authority currently holds £230 million of loans, an increase of £15 million on the previous year, as part of its strategy for funding previous years' capital programmes. The balance sheet forecast in table 1 shows that the Authority expects to borrow up to £254m in 2016/17. The Authority may also borrow additional sums to pre-fund future years' requirements, providing this does not exceed the authorised limit for borrowing of £338 million.

4.2 <u>Objectives</u>**:**

The Authority's chief objective when borrowing money is to strike an appropriately low risk balance between securing low interest costs and achieving certainty of those costs over the period for which funds are required. The flexibility to renegotiate loans should the Authority's long-term plans change is a secondary objective.

4.3 Strategy:

Given the significant cuts to public expenditure and in particular to local government funding, the Authority's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. With short-term interest rates currently much lower than long-term rates, it is likely to be more cost effective in the short-term to either use internal resources, or to borrow short-term loans instead.

By doing so, the Authority is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. The benefits of internal and short-term borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise. Arlingclose will assist the Authority with this 'cost of carry' and breakeven analysis. Its output may determine whether the Authority borrows additional sums at long-term fixed rates in 2016/17 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

In addition, the Authority may borrow short-term loans to cover unexpected cash flow shortages.

4.4 Sources:

The approved sources of long-term and short-term borrowing are:

- Public Works Loan Board (PWLB) and any successor body
- any institution approved for investments (see below)
- any other bank or building society authorised to operate in the UK
- UK public and private sector pension funds (except Devon Local Government Pension Fund)
- capital market bond investors
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues
- any other counterparty that are approved by the authority's TM advisors.

In addition, capital finance may be raised by the following methods that are not borrowing, but may be classed as other debt liabilities:

- operating and finance leases
- hire purchase
- Private Finance Initiative
- sale and leaseback

The Authority has previously raised some of its long-term borrowing from the PWLB and through LOBOs but it continues to investigate other sources of finance, such as local authority loans and bank loans that may be available at more favourable rates.

4.5 LGA Bond Agency:

UK Municipal Bonds Agency plc was established in 2014 by the Local Government Association as an alternative to the PWLB. It plans to issue bonds on the capital markets and lend the proceeds to local authorities. This will be a more complicated source of finance than the PWLB for two reasons: borrowing authorities may be required to provide bond investors with a joint and several guarantee over the very small risk that other local authority borrowers default on their loans; and there will be a lead time of several months between committing to borrow and knowing the interest rate payable. Any decision to borrow from the Agency will therefore be the subject of a separate report to the Treasury Management Board.

4.6 LOBOs:

The Authority holds £100m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate as set dates, following which the Authority has the option to either accept the new rate or to repay the loan at no additional cost. £20m of these LOBOS have options during 2016/17, and although the Authority understands that lenders are unlikely to exercise their options in the current low interest rate environment, there remains an element of refinancing risk. The Authority will take the option to repay LOBO loans at no cost if it has the opportunity to do so. Total borrowing via LOBO loans will be limited to £100m.

4.7 Short-term and Variable Rate loans:

These loans leave the Authority exposed to the risk of short-term interest rate rises and are therefore subject to the limit on the net exposure to variable interest rates in the treasury management indicators below.

4.8 Debt Rescheduling:

The PWLB allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. Other lenders may also be prepared to negotiate premature redemption terms. The Authority may take advantage of this and replace some loans with new loans, or repay loans without replacement, where this is expected to lead to an overall cost saving or a reduction in risk.

5. Investment Strategy

5.1 The Authority holds invested funds, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the Authority's investment balance has ranged between £60 and £70 million, and is expected to remain about the same in the forthcoming year.

5.2 Objectives:

Both the CIPFA Code and the CLG Guidance require the Authority to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Authority's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk receiving unsuitably low investment income.

5.3 Strategy:

Given the increased risk and continued low returns from short-term unsecured bank investments, the Authority continues to hold its investments in more secure, lower yielding asset classes. The authority holds £20m as a longer-term investment in the CCLA Property Fund and this gives a higher return than the short term investments. The majority of the Authorities surplus cash is currently invested in short-term unsecured bank deposits, certificates of deposit, Local Authorities and money market funds. This diversification will represent a continuation of the new strategy adopted in 2015/16.

5.4 Approved Counterparties:

The Authority may invest its surplus funds with any of the counterparty types in table 2 below, subject to the cash limits (per counterparty) and the time limits shown.

Table 2: Approved Investment Counterparties and Limits

Credit Rating	Banks Unsecured	Banks Secured	Government	Corporates	Registered Providers
UK Govt	n/a	n/a	£ Unlimited 50 years	n/a	n/a
AAA	£6m 5 years	£12m 20 years	£20m 50 years	£6m 20 years	£6m 20 years
AA+	£6m 5 years	£12m 10 years	£12m 25 years	£6m 10 years	£6m 10 years
AA	£6m 4 years	£12m 5 years	£12m 15 years	£6m 5 years	£6m 10 years
AA-	£5m 3 years	£12m 4 years	£12m 10 years	£6m 4 years	£6m 10 years
A+	£5m 2 years	£12m 3 years	£6m 5 years	£6m 3 years	£6m 5 years
A	£4m 13 months	£12m 2 years	£6m 5 years	£6m 2 years	£6m 5 years
A-	£4m 6 months	£12m 13 months	£6m 5 years	£6m 13 months	£6m 5 years
BBB+	£3m 100 days	£5m 6 months	£2m 2 years	£2m 6 months	£2m 2 years
BBB	£0m next day only	£5m 100 days	n/a	n/a	n/a
None	n/a	n/a	£12m 25 years	n/a	£3m 5 years
Pooled funds	£20m per fund				

This table must be read in conjunction with the notes below

5.5 Credit Rating:

Investment decisions are made by reference to the lowest published long-term credit rating from Fitch, Moody's or Standard & Poor's. Where available, the credit rating relevant to the specific investment or class of investment is used, otherwise the counterparty credit rating is used.

5.6 Banks Unsecured:

Accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies, other than multilateral development banks. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail. Unsecured investment with banks rated BBB are restricted to overnight deposits at the Authority's current account bank.

5.7 Banks Secured:

Covered bonds, reverse repurchase agreements and other collateralised arrangements with banks and building societies. These investments are secured on the bank's assets, which limits the potential losses in the unlikely event of insolvency, and means that they are exempt from bail-in. Where there is no investment specific credit rating, but the collateral upon which the investment is secured has a credit rating, the higher of the collateral credit rating and the counterparty credit rating will be used to determine cash and time limits. The combined secured and unsecured investments in any one bank will not exceed the cash limit for secured investments.

5.8 Government:

Loans, bonds and bills issued or guaranteed by national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail-in, and there is an insignificant risk of insolvency. Investments with the UK Central Government may be made in unlimited amounts for up to 50 years.

5.9 Corporates:

Loans, bonds and commercial paper issued by companies other than banks and registered providers. These investments are not subject to bail-in, but are exposed to the risk of the company going insolvent. Loans to unrated companies will only be made as part of a diversified pool in order to spread the risk widely.

5.10 Registered Providers:

Loans and bonds issued by, guaranteed by or secured on the assets of Registered Providers of Social Housing, formerly known as Housing Associations. These bodies are tightly regulated by the Homes and Communities Agency and, as providers of public services, they retain a high likelihood of receiving government support if needed.

5.11 Pooled Funds:

Shares in diversified investment vehicles consisting of the any of the above investment types, plus equity shares and property. These funds have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a fee. Short-term Money Market Funds that offer same-day liquidity and very low or no volatility will be used as an alternative to instant access bank accounts, while pooled funds whose value changes with market prices and/or have a notice period will be used for longer investment periods.

Bond, equity and property funds offer enhanced returns over the longer term, but are more volatile in the short term. These allow the Authority to diversify into asset classes other than cash without the need to own and manage the underlying investments. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Authority's investment objectives will be monitored regularly.

5.12 Risk Assessment and Credit Ratings:

Credit ratings are obtained and monitored by the Authority's treasury advisers, who will notify changes in ratings as they occur. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:

- no new investments will be made,
- any existing investments that can be recalled or sold at no cost will be, and
- full consideration will be given to the recall or sale of all other existing investments with the affected counterparty.

Where a credit rating agency announces that a credit rating is on review for possible downgrade (also known as "rating watch negative" or "credit watch negative") so that it may fall below the approved rating criteria, then only investments that can be withdrawn on the next working day will be made with that organisation until the outcome of the review is announced. This policy will not apply to negative outlooks, which indicate a long-term direction of travel rather than an imminent change of rating.

5.13 Other Information on the Security of Investments:

The Authority understands that credit ratings are good, but not perfect, predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations in which it invests, including credit default swap prices, financial statements, information on potential government support and reports in the quality financial press. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may meet the credit rating criteria.

When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008 and 2011, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, the Authority will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments to maintain the required level of security. The extent of these restrictions will be in line with prevailing financial market conditions. If these restrictions mean that insufficient commercial organisations of high credit quality are available to invest the Authority's cash balances, then the surplus will be deposited with the UK Government, via the Debt Management Office or invested in government treasury bills for example, or with other local authorities. This will cause a reduction in the level of investment income earned, but will protect the principal sum invested.

5.14 Specified Investments:

The CLG Guidance defines specified investments as those:

- denominated in pound sterling,
- due to be repaid within 12 months of arrangement,
- not defined as capital expenditure by legislation, and
- invested with one of:
  - the UK Government,
  - a UK local authority, parish council or community council, or
  - a body or investment scheme of "high credit quality".

The Authority defines "high credit quality" organisations and securities as those having a credit rating of [A-] or higher that are domiciled in the UK or a foreign country with a sovereign rating of [AA+] or higher. For money market funds and other pooled funds "high credit quality" is defined as those having a credit rating of [A-] or higher.

5.15 Non-specified Investments:

Any investment not meeting the definition of a specified investment is classed as non-specified. The Authority does not intend to make any investments denominated in foreign currencies, nor any that are defined as capital expenditure by legislation, such as company shares. Non-specified investments will therefore be limited to long-term investments, i.e. those that are due to mature 12 months or longer from the date of arrangement, and investments with bodies and schemes not meeting the definition on high credit quality. Limits on non-specified investments are shown in table 3 below.

Table 3: Non-Specified Investment Limits

	Cash limit
Total long-term investments	£40m
Total investments without credit ratings or rated below A-	£10m
Total investments with institutions domiciled in foreign countries rated below AA+	£0m
Total non-specified investments	£50m

5.16 Investment Limits:

The Authority's revenue reserves available to cover investment losses are forecast to be £45 million on 31st March 2016. In order that no more than 40% of available reserves will be put at risk in the case of a single default, the maximum that will be lent to any one organisation (other than the UK Government) will be £20 million. A group of banks under the same ownership will be treated as a single organisation for limit purposes. Limits will also be placed on fund managers, investments in brokers' nominee accounts, foreign countries and industry sectors as below. Investments in pooled funds and multilateral development banks do not count against the limit for any single foreign country, since the risk is diversified over many countries.

Table 4: Investment Limits

	Cash limit
Any single organisation, except the UK Central Government	£12m each
UK Central Government	unlimited
Any group of organisations under the same ownership	£20m per group
Any group of pooled funds under the same management	£25m per manager
Negotiable instruments held in a broker's nominee account	£40m per broker
Foreign countries	£12m per country
Registered Providers	£12m in total
Unsecured investments with Building Societies	£10m in total
Loans to unrated corporates	£5m in total
Money Market Funds	£40m in total

5.17 Liquidity Management:

The Authority uses cash flow forecasting spreadsheet to determine the maximum period for which funds may prudently be committed. The forecast is compiled on a prudent basis to minimise the risk of the Authority being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Authority's medium term financial plan and cash flow forecast.

6. Treasury Management Indicators

The Authority measures and manages its exposures to treasury management risks using the following indicators.

6.1 Security:

The Authority has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment.

	Target
Portfolio average credit rating	A

6.2 Liquidity:

The Authority has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three month period, without additional borrowing.

	Target
Total cash available within 3 months	£15m

6.3 Interest Rate Exposures:

This indicator is set to control the Authority's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the proportion of net principal borrowed will be:

	2016/17	2017/18	2018/19
Upper limit on fixed interest rate exposure	210%	210%	210%
Upper limit on variable interest rate exposure	80%	80%	80%

Fixed rate investments and borrowings are those where the rate of interest is fixed for at least 12 months, measured from the start of the financial year or the transaction date if later. All other instruments are classed as variable rate.

6.4 Maturity Structure of Borrowing:

This indicator is set to control the Authority's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing will be:

	Upper	**Lower**
Under 12 months	100%	0%
12 months and within 24 months	100%	0%
24 months and within 5 years	100%	0%
5 years and within 10 years	100%	0%
10 years and above	100%	0%

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

6.5 Principal Sums Invested for Periods Longer than 364 days:

The purpose of this indicator is to control the Authority's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end will be:

	2016/17	**2017/18**	**2018/19**
Limit on principal invested beyond year end	£40m	£35m	£35m

7.1 <u>Other Items</u>

There are a number of additional items that the Authority is obliged by CIPFA or CLG to include in its Treasury Management Strategy.

7.2 Policy on Use of Financial Derivatives:

Local authorities have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate risk (e.g. interest rate collars and forward deals) and to reduce costs or increase income at the expense of greater risk (e.g. LOBO loans and callable deposits). The general power of competence in Section 1 of the *Localism Act 2011* removes much of the uncertainty over local authorities' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment).

The Authority will only use standalone financial derivatives (such as swaps, forwards, futures and options) where they can be clearly demonstrated to reduce the overall level of the financial risks that the Authority is exposed to. Additional risks presented, such as credit exposure to derivative counterparties, will be taken into account when determining the overall level of risk. Embedded derivatives, including those present in pooled funds and forward starting transactions, will not be subject to this policy, although the risks they present will be managed in line with the overall treasury risk management strategy.

Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria. The current value of any amount due from a derivative counterparty will count against the counterparty credit limit and the relevant foreign country limit.

7.3 Investment Training:

The needs of the Authority's treasury management staff for training in investment management are assessed every twelve months as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change.

Staff regularly attend training courses, seminars and conferences provided by Arlingclose and CIPFA. Relevant staff are also encouraged to study professional qualifications from CIPFA, the Association of Corporate Treasurers and other appropriate organisations.

7.4 Investment Advisers:

The Authority has appointed Arlingclose Limited as treasury management advisers and receives specific advice on investment, debt and capital finance issues. The quality of this service is controlled by quarterly review meetings and periodically tendering for the provision of Treasury Management Consultancy services.

7.6 Investment of Money Borrowed in Advance of Need:

The Authority may, from time to time, borrow in advance of need, where this is expected to provide the best long term value for money. Since amounts borrowed will be invested until spent, the Authority is aware that it will be exposed to the risk of loss of the borrowed sums, and the risk that investment and borrowing interest rates may change in the intervening period. These risks will be managed as part of the Authority's overall management of its treasury risks.

The total amount borrowed will not exceed the authorised borrowing limit of £338 million. The maximum period between borrowing and expenditure is expected to be two years, although the Authority is not required to link particular loans with particular items of expenditure.

8. Financial Implications

The budget for investment income in 2016/17 is £0.77 million, based on an average investment portfolio of £68 million at an interest rate of 1.14%. The budget for debt interest payable in 2016/17 is £7.90 million, based on an average debt portfolio of £230 million at an average interest rate of 3.4%. If actual levels of investments and borrowing, and actual interest rates differ from those forecast, performance against budget will be correspondingly different.

9. Other Options Considered

The CLG Guidance and the CIPFA Code do not prescribe any particular treasury management strategy for local authorities to adopt. The Section 151 Officer, having consulted the Cabinet Member for Finance, believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed below.

Alternative	Impact on income and expenditure	Impact on risk management
Invest in a narrower range of counterparties and/or for shorter times	Interest income will be lower	Lower chance of losses from credit related defaults, but any such losses may be greater
Invest in a wider range of counterparties and/or for longer times	Interest income will be higher	Increased risk of losses from credit related defaults, but any such losses may be smaller
Borrow additional sums at long-term fixed interest rates	Debt interest costs will rise; this is unlikely to be offset by higher investment income	Higher investment balance leading to a higher impact in the event of a default; however long-term interest costs may be more certain
Borrow short-term or variable loans instead of long-term fixed rates	Debt interest costs will initially be lower	Increases in debt interest costs will be broadly offset by rising investment income in the medium term, but long term costs may be less certain
Reduce level of borrowing	Saving on debt interest is likely to exceed lost investment income	Reduced investment balance leading to a lower impact in the event of a default; however long-term interest costs may be less certain

10.0 Change of Minimum revenue Provision (MRP) Policy

10.1 MRP Review

Under regulation 27 of the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 SI 2003/3146, as amended, local authorities are required to charge to their revenue account for each financial year MRP to account for the cost of their unfinanced capital expenditure.

Prior to its amendment by the 2008 Regulations, regulation 28 (as amended by regulation 3(1), and read with regulation 3(2) and (3), of the 2007 Regulations) sets out the method authorities were required to follow in calculating MRP.

There has also been a recent change of advice from CIPFA on MRP calculations and the use of the annuity method. Prior years involved detailed calculations which were very prescriptive but these have been replaced with a requirement that local authorities calculate an amount of MRP which they consider to be prudent.

10.2 Change of Policy

During 2015/16 the Council has undertaking a review of its MRP calculation method and accounting assumptions. The Council's calculations were driven by a very complex spreadsheet that needed a full overhaul. The Council therefore engaged its TM advisors, Arlingclose to review and advise best practice. The main conclusions were that, due to the way we were calculating our annual MRP charge has resulted in an over-provision for many years and it also recommended a change in the calculation method.

The Council wants to match the economic benefits from its assets with the life of those assets. Therefore the Council wants to use the annuity method which not only spreads the cost of the borrowing over the life of the assets but it also takes into account the time value of money.

The council's previous method of calculating MRP was to spread the cost of borrowing in a straight line over a maximum of 25 years. The current council tax payers would therefore pay a relative higher charge than council tax payers in the future. e.g. if an asset cost £20m to build and has a life of 20 years then there would have been a £1m charged each year on the straight line basis. The annuity method takes into account the time value because £1m today has a higher value (NPV) than £1m in 20 years time.

The resulting change from the over provision of MRP in prior years will be to reduce the MRP charge in 2015/16 and 2016/17 by £3.65m in each year. The change of calculation method to the annuity method will reduce the MRP charge for the following years as follows; 2016/17 £1.05m; 2017/18 £0.89m; 2018/19 £0.73m; 2019/20 £0.57m (these figures would be subject to additional MRP charges for assets added during these periods).

The details of the MRP policy are shown in Appendix E.

10.3 Recommendations

Cabinet recommends Council to approve the change of policy in the calculation of the Minimum Revenue Provision (MRP) using the annuity method with effect from 2015/16.

Appendix A – Treasury Management Policy Statement

INTRODUCTION AND BACKGROUND

- The Council adopts the key recommendations of CIPFA's Treasury Management in the Public Services: Code of Practice (the Code), as described in Section 5 of the Code.

- Accordingly, the Council will create and maintain, as the cornerstones for effective treasury management:-

    - A treasury management policy statement, stating the policies, objectives and approach to risk management of its treasury management activities

    - Suitable treasury management practices (TMPs), setting out the manner in which the Council will seek to achieve those policies and objectives, and prescribing how it will manage and control those activities.

- The Council (i.e. full Council) will receive reports on its treasury management policies, practices and activities including, as a minimum, an annual strategy and plan in advance of the year, a mid-year review and an annual report after its close, in the form prescribed in its TMPs.

- The Council delegates responsibility for the implementation and monitoring of its treasury management policies and practices to Cabinet and the Audit Committee and for the execution and administration of treasury management decisions to the Section 151 Officer, who will act in accordance with the organisation's policy statement and TMPs and CIPFA's Standard of Professional Practice on Treasury Management.

- The Council nominates the Audit Committee to be responsible for ensuring effective scrutiny of the treasury management strategy and policies.

POLICIES AND OBJECTIVES OF TREASURY MANAGEMENT ACTIVITIES

- The Council defines its treasury management activities as "The management of the Council's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

- This Council regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation, and any financial instruments entered into to manage these risks.

- This Council acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable performance measurement techniques, within the context of effective risk management.

- The Council's borrowing will be affordable, sustainable and prudent and consideration will be given to the management of interest rate risk and refinancing risk. The source from which the borrowing is taken and the type of borrowing should allow the Council transparency and control over its debt.

- The Council's primary objective in relation to investments remains the security of capital. The liquidity or accessibility of the Authority's investments followed by the yield earned on investments remain important but are secondary considerations.

Appendix B – Arlingclose Economic & Interest Rate Forecast November 2015

Underlying assumptions:

- UK economic growth softened in Q3 2015 but remained reasonably robust; the first estimate for the quarter was 0.5% and year-on-year growth fell slightly to 2.3%. Negative construction output growth offset fairly strong services output, however survey estimates suggest upwards revisions to construction may be in the pipeline.

- Household spending has been the main driver of GDP growth through 2014 and 2015 and remains key to growth. Consumption will continue to be supported by real wage and disposable income growth.

- Annual average earnings growth was 3.0% (including bonuses) in the three months to August. Given low inflation, real earnings and income growth continue to run at relatively strong levels and could feed directly into unit labour costs and households' disposable income. Improving productivity growth should support pay growth in the medium term. The development of wage growth is one of the factors being closely monitored by the MPC.

- Business investment indicators continue to signal strong growth. However the outlook for business investment may be tempered by the looming EU referendum, increasing uncertainties surrounding global growth and recent financial market shocks.
- Inflation is currently very low and, with a further fall in commodity prices, will likely remain so over the next 12 months. The CPI rate is likely to rise towards the end of 2016.

- China's growth has slowed and its economy is performing below expectations, which in turn will dampen activity in countries with which it has close economic ties; its slowdown and emerging market weakness will reduce demand for commodities. Other possible currency interventions following China's recent devaluation will keep sterling strong against many global currencies and depress imported inflation.

- Strong US labour market data and other economic indicators suggest recent global turbulence has not knocked the American recovery off course. Although the timing of the first rise in official interest rates remains uncertain, a rate rise by the Federal Reserve seems significantly more likely in December given recent data and rhetoric by committee members.

- Longer term rates will be tempered by international uncertainties and weaker global inflation pressure.

Forecast:

- Arlingclose forecasts the first rise in UK Bank Rate in Q3 2016. Further weakness in inflation, and the MPC's expectations for its path, suggest policy tightening will be pushed back into the second half of the year. Risks remain weighted to the downside. Arlingclose projects a slow rise in Bank Rate, the appropriate level of which will be lower than the previous norm and will be between 2 and 3%.
- The projection is for a shallow upward path for medium term gilt yields, with continuing concerns about the Eurozone, emerging markets and other geo-political events, weighing on risk appetite, while inflation expectations remain subdued.
- The uncertainties surrounding the timing of UK and US monetary policy tightening, and global growth weakness, are likely to prompt short term volatility in gilt yields.

	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18
Official Bank Rate													
Upside risk		0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.50	0.50
Arlingclose Central Case	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.25	1.50	1.50	1.75	1.75
Downside risk				-0.25	-0.25	-0.50	-0.50	-0.75	-0.75	-1.00	-1.00	-1.25	-1.25
3-month LIBID rate													
Upside risk	0.20	0.30	0.30	0.30	0.35	0.35	0.35	0.35	0.40	0.40	0.40	0.40	0.40
Arlingclose Central Case	0.55	0.60	0.70	0.80	0.95	1.05	1.15	1.30	1.40	1.55	1.65	1.80	1.85
Downside risk		-0.20	-0.30	-0.45	-0.55	-0.65	-0.80	-0.90	-1.05	-1.10	-1.20	-1.20	-1.20
1-yr LIBID rate													
Upside risk	0.25	0.35	0.35	0.35	0.40	0.40	0.40	0.40	0.45	0.45	0.45	0.45	0.45
Arlingclose Central Case	1.10	1.20	1.35	1.45	1.55	1.70	1.80	1.95	2.00	2.10	2.15	2.15	2.15
Downside risk	-0.15	-0.25	-0.35	-0.50	-0.60	-0.70	-0.85	-0.95	-1.10	-1.15	-1.25	-1.25	-1.25
5-yr gilt yield													
Upside risk	0.40	0.50	0.50	0.50	0.55	0.55	0.55	0.55	0.60	0.60	0.60	0.60	0.60
Arlingclose Central Case	1.50	1.55	1.60	1.70	1.80	1.90	2.00	2.10	2.20	2.25	2.30	2.35	2.35
Downside risk	-0.35	-0.45	-0.55	-0.60	-0.70	-0.80	-0.90	-1.00	-1.10	-1.15	-1.20	-1.25	-1.25
10-yr gilt yield													
Upside risk	0.40	0.50	0.50	0.50	0.55	0.55	0.55	0.55	0.60	0.60	0.60	0.60	0.60
Arlingclose Central Case	2.00	2.05	2.10	2.20	2.30	2.40	2.50	2.60	2.65	2.70	2.75	2.80	2.80
Downside risk	-0.35	-0.45	-0.55	-0.60	-0.70	-0.80	-0.90	-1.00	-1.10	-1.15	-1.20	-1.25	-1.25
20-yr gilt yield													
Upside risk	0.40	0.50	0.50	0.50	0.55	0.55	0.55	0.55	0.60	0.60	0.60	0.60	0.60
Arlingclose Central Case	2.45	2.50	2.55	2.55	2.60	2.65	2.70	2.75	2.80	2.85	2.90	2.95	2.95
Downside risk	-0.30	-0.40	-0.50	-0.55	-0.65	-0.75	-0.85	-0.95	-1.05	-1.10	-1.15	-1.20	-1.20
50-yr gilt yield													
Upside risk	0.40	0.50	0.50	0.50	0.55	0.55	0.55	0.55	0.60	0.60	0.60	0.60	0.60
Arlingclose Central Case	2.45	2.50	2.55	2.60	2.65	2.70	2.75	2.80	2.85	2.90	2.95	3.00	3.00
Downside risk	-0.25	-0.35	-0.45	-0.50	-0.60	-0.70	-0.80	-0.90	-1.00	-1.05	-1.10	-1.15	-1.15

Appendix C – Existing Investment & Debt Portfolio Position

	31/12/2015 **Actual Portfolio £m**	31/12/2015 **Average Rate %**
External Borrowing:		
PWLB – Fixed Rate	44.25	5.76
PWLB – Variable Rate	0.00	0.00
Local Authorities	80.30	0.39
LOBO Loans	100.00	4.38
Total External Borrowing	**224.55**	**3.23**
Other Long Term Liabilities:		
PFI	28.61	
Finance Leases	1.73	n/a
Cornwall Council (TBTF)	8.42	n/a
Total Gross External Debt	**263.31**	
Investments:		
Managed in-house		
Short-term investments	37.14	0.76
Long-term investments	11.00	variable
Managed externally		
Fund Managers		
Pooled Funds	20.00	variable
Total Investments	**68.14**	
Net Debt	**195.17**	

Appendix D - Prudential Indicators 2016/17

The Local Government Act 2003 requires the Authority to have regard to the Chartered Institute of Public Finance and Accountancy's *Prudential Code for Capital Finance in Local Authorities* (the Prudential Code) when determining how much money it can afford to borrow. The objectives of the Prudential Code are to ensure, within a clear framework, that the capital investment plans of local authorities are affordable, prudent and sustainable, and that treasury management decisions are taken in accordance with good professional practice. To demonstrate that the Authority has fulfilled these objectives, the Prudential Code sets out the following indicators that must be set and monitored each year.

Estimates of Capital Expenditure: The Authority's planned capital expenditure and financing may be summarised as follows.

Capital Expenditure and Financing	2015/16 Revised £m	2016/17 Estimate £m	2017/18 Estimate £m	2018/19 Estimate £m
General Fund	93.19	74.91	55.23	48.19
Total Expenditure	**93.19**	**74.91**	**55.23**	**48.19**
Capital Receipts	8.51	8.51	8.51	8.51
Grants & Contributions	60.22	48.08	37.35	34.15
Reserves	-	-	-	-
Revenue	1.90	2.59	0.93	0.53
Borrowing	22.56	15.73	8.44	5.00
Leasing and PFI	-	-	-	-
Total Financing	**93.19**	**74.91**	**55.23**	**48.19**

Estimates of Capital Financing Requirement: The Capital Financing Requirement (CFR) measures the Authority's underlying need to borrow for a capital purpose.

Capital Financing Requirement	31.03.16 Revised £m	31.03.17 Estimate £m	31.03.18 Estimate £m	31.03.19 Estimate £m
General Fund	313.50	329.23	337.67	342.67
Total CFR	**313.50**	**329.23**	**337.67**	**342.67**

The CFR is forecast to rise by £107m over the next three years as capital expenditure financed by debt outweighs resources put aside for debt repayment.

Gross Debt and the Capital Financing Requirement: In order to ensure that over the medium term debt will only be for a capital purpose, the Authority should ensure that debt does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. This is a key indicator of prudence.

Debt	**31.03.16 Revised £m**	**31.03.17 Estimate £m**	**31.03.18 Estimate £m**	**31.03.19 Estimate £m**
Borrowing	238.02	253.75	262.19	267.19
Finance leases	1.73	1.50	1.50	1.50
PFI liabilities	37.21	36.50	36.50	36.50
Total Debt	**276.96**	**291.75**	**300.19**	**305.19**

Total debt is expected to remain below the CFR during the forecast period.

Operational Boundary for External Debt: The operational boundary is based on the Authority's estimate of most likely (i.e. prudent but not worst case) scenario for external debt. It links directly to the Authority's estimates of capital expenditure, the capital financing requirement and cash flow requirements, and is a key management tool for in-year monitoring. Other long-term liabilities comprise finance lease, Private Finance Initiative and other liabilities that are not borrowing but form part of the Authority's debt.

Operational Boundary	**2015/16 Revised £m**	**2016/17 Estimate £m**	**2017/18 Estimate £m**	**2018/19 Estimate £m**
Borrowing	238.02	253.75	262.19	267.19
Other long-term liabilities	38.94	38.00	38.00	38.00
Total Debt	**276.96**	**291.75**	**300.19**	**305.19**

Authorised Limit for External Debt: The authorised limit is the affordable borrowing limit determined in compliance with the Local Government Act 2003. It is the maximum amount of debt that the Authority can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

Authorised Limit	**2015/16 Revised £m**	**2016/17 Estimate £m**	**2017/18 Estimate £m**	**2018/19 Estimate £m**
Borrowing	280.00	300.00	320.00	340.00

Other long-term liabilities	39.00	38.00	38.00	38.00
Total Debt	**319.00**	**338.00**	**358.00**	**378.00**

Ratio of Financing Costs to Net Revenue Stream: This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs, net of investment income.

Ratio of Financing Costs to Net Revenue Stream	2015/16 Revised %	2016/17 Estimate %	2017/18 Estimate %	2018/19 Estimate %
General Fund	5.13%	4.95%	4.88%	4.71%

Incremental Impact of Capital Investment Decisions: This is an indicator of affordability that shows the impact of capital investment decisions on Council Tax levels. The incremental impact is the difference between the total revenue budget requirement of the current approved capital programme and the revenue budget requirement arising from the capital programme proposed.

Incremental Impact of Capital Investment Decisions	2016/17 Estimate £	2017/18 Estimate £	2018/19 Estimate £
General Fund - increase in annual band D Council Tax	5.8	10.2	16.4

Adoption of the CIPFA Treasury Management Code: The Authority adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* in April 2002.

Appendix E Minimum Revenue Provision Statement

Where the Authority finances capital expenditure by debt, it must put aside resources to repay that debt in later years. The amount charged to the revenue budget for the repayment of debt is known as Minimum Revenue Provision (MRP), although there has been no statutory minimum since 2008. The Local Government Act 2003 requires the Authority to have regard to the Department for Communities and Local Government's *Guidance on Minimum Revenue Provision* (the CLG Guidance) most recently issued in 2011.

The broad aim of the CLG Guidance is to ensure that debt is repaid over a period that is either reasonably commensurate with that over which the capital expenditure provides benefits, or, in the case of borrowing supported by Government Revenue Support Grant, reasonably commensurate with the period implicit in the determination of that grant.

The CLG Guidance requires the Authority to approve an Annual MRP Statement each year, and recommends a number of options for calculating a prudent amount of MRP. The following statement incorporates options recommended in the Guidance as well as locally determined prudent methods.

Option 1

For capital expenditure incurred before 1st April 2008, and for supported capital expenditure incurred on or after that date, MRP will be determined in accordance with the former regulations that applied on 31st March 2008, incorporating an "Adjustment A".

Option 2

For capital expenditure incurred before 1st April 2008 and for supported capital expenditure incurred on or after that date, MRP will be determined as 4% of the Capital Financing Requirement in respect of that expenditure.

Option 3

For capital expenditure incurred after 31st March 2008, MRP will be determined by charging the expenditure over the expected useful life of the relevant assets in equal instalments *or*

the alternative method as the principal repayment on an annuity method, starting in the year after the asset becomes operational. MRP on purchases of freehold land will be charged over 50 years. MRP on expenditure not related to fixed assets but which has been capitalised by regulation or direction will be charged over 20 years.

Option 4

For capital expenditure incurred after 31st March 2008, MRP will be determined as being equal to the accounting charge for depreciation.

For assets acquired by finance leases or the Private Finance Initiative, MRP will be determined as being equal to the element of the rent or charge that goes to write down the balance sheet liability.

Capital expenditure incurred during 2016/17 will not be subject to a MRP charge until 2017/18.

New MRP Policy

From 2015/16 the council will change its MRP policy to use the alternative option in Option 3 and use the annuity method, starting in the year after the asset becomes operational.

Guidance on the calculation method is given by CIPFA in Chapter 6 of its publication Practitioners' Guide to Capital Finance in Local Government (CIPFA 2008) (ISBN 978 1 84508 175 1).

This document states "The informal commentary on the statutory guidance suggests that the annuity method may be particularly attractive in projects where revenues will increase over time. However, it is arguably the case that the annuity method provides a fairer charge than equal instalments as it takes account of the time value of money, whereby paying £100 in 10 years' time is less of a burden than paying £100 now. The schedule of charges produced by the annuity method thus results in a consistent charge over an asset's life, taking into the real value of the amounts when they fall due. The annuity method would then be a prudent basis for providing for assets that provided steady flow of benefits over their useful life."

Borrowing
For new borrowing under the prudential system for which no Government support is being given and is therefore self-financed, MRP will be made using the annuity method over the life of the asset (Option 3).

Capitalisation Directions
For capitalisation directions on expenditure incurred since 1 April 2008 MRP will be made using the annuity method over 50 years.

PFI/Leases
MRP in respect of PFI and leases brought on the Balance Sheet under the 2009 SORP and IFRS will match the annual principal repayment for the associated deferred liability.

Any loan or investment to an organisation defined as capital expenditure will not attract MRP. The original capital expenditure will be met from the capital receipt on the maturity of the loan/investment.

MRP will commence in the financial year following the one in which the expenditure is incurred, except for expenditure funded by borrowing where the project is not complete at 31st March 2016 (classified as under construction). MRP will be deferred until the construction is complete and operational with the charge to be made in the year following completion.

Capital expenditure incurred during 2016/17 will not be subject to a MRP charge until the year after the asset becomes operational.